VZCZCXYZ0010
PP RUEHWEB

DE RUEHAK #1057/01 2041725
ZNY CCCCC ZZH
P 231725Z JUL 09
FM AMEMBASSY ANKARA
TO RUEHC/SECSTATE WASHDC PRIORITY 0304
INFO RUEHIT/AMCONSUL ISTANBUL PRIORITY 6052
RUEATRS/TREASURY DEPT WASHDC PRIORITY

C O N F I D E N T I A L ANKARA 001057

SIPDIS

E.O. 12958: DECL: 07/23/2019
TAGS: ECON EFIN TU
SUBJECT: TURKEY: WARNING SIGNS FOR THE ECONOMY

Classified By: Economic Counselor Dale Eppler for reasons 1.4 b, d

¶1. (C) Summary: The Turkish economy remains in deep recession. While analysts expect it to recover by late 2009 or early 2010, there are several downside risks -- internal and external -- that threaten to delay the recovery and move it to stagnation in 2010. The intent of this cable is to explain the financial issues involved and lay out key risk indicators to watch for over the next six to nine months. On the domestic side, key signs of a deteriorating economy would be: (1) a sharp increase in the GOT benchmark bond yield or a very weakly-attended GOT bond auction; and/or (2) a continued decline in Turkish firms' external debt rollover ratio combined with a sustained decline in capital inflows. On the external side, watch for: (1) an uptick in global energy and, to a lesser extent, food prices; (2) A return to global market volatility; (3) A prolonged recession in Europe; and/or (4) a deterioration in global credit conditions that limits Turkish firms' access to external credit and their ability to roll over external debt. An IMF program would reduce these risks substantially. However, the GOT appears to have adopted a wait and see attitude towards a new Fund agreement, as it is hard to come up with a politically positive scenario in which Turkey signs an agreement before the economy experiences real stress. End summary.

Domestic Warning Signs to Watch For

¶2. (C) On the domestic side, warning signs to watch for include:

-- A sharp increase in the government's benchmark bond yield or a very weakly-attended government bond auction. Government revenues have fallen off dramatically, in line with Turkey's deep recession. At the same time, the GOT has significantly increased spending since late 2008, first in the run-up to local elections in March and since then in a questionable effort to provide fiscal stimulus. This has compelling the GOT to dramatically increase its market borrowing. Its ex-interest budget balance will move from surplus to a significant deficit this year: The change year-on-year is equivalent to about 4 percent of GDP. Failure to address this in the medium term - by cutting back on expenditures and implementing structural reforms - will make GOT debt less attractive to markets. This would, in turn, likely result in lower demand for its securities and higher interest rates, making additional borrowing more expensive and potentially trapping it in an unsustainable pattern of further borrowing at increasingly higher rates. Such a scenario would be particularly stressful if it occurred during the first four months of 2010, when the GOT faces exceptionally large payments (on average, $12 billion per month) that it will need to refinance. Sustained, stepped-up GOT borrowing - largely financed by the local banking sector - also will leave less credit available for the private sector, slowing investment and complicating Turkey's recovery.

-- Continued dropoff in Turkish firms' external debt rollover ratio combined with a sustained decline in capital inflows through Turkey,s errors and omissions account. Turkish corporates faced very large ($2.6 billion per month) external debt repayments in December 2008 and January 2009, a time when global credit was very scarce. This put pressure on Turkish asset prices and threatened the viability of weaker firms. Companies have compensated for this tighter global credit by bringing onshore FX deposits held abroad. This inflow likely accounts for much of the cumulative $19 billion increase since November in the "net errors and omissions" (NEO) account of Turkey's balance of payments. However, no one knows the composition or source of this inflow, making it difficult to rely on it continuing to cover Turkey's external financing gap. A continued slide in the corporate sector's external rollover ratio that coincided with a consistent decline in NEO inflows would likely lower investment, curb growth and increase corporate default risk. This risk will become particularly pointed from September 2009 to January 2010, when Turkish corporates' monthly external obligations will jump to an average $2.8 billion per month.

External Warning Signs to Watch For

¶3. (C) In addition to Turkey-specific events, economic stress could originate in external events. Here are four to watch for:

-- An uptick in global energy and, to a lesser extent, food prices. Energy imports have traditionally accounted for much of Turkey,s large current account deficit. Combined with a sharp drop in non-energy imports, dramatically lower energy prices over the past year have cut Turkey's current account deficit in half. A return to higher energy prices would reverse this trend and bring renewed downward pressure on the lira, which has been stable since March. More broadly, a rise in global commodity prices (energy and food) would reinforce recently-renewed concerns about inflationary pressures later this year. Inflation has come down significantly in the past year - to 5.7% in June - but aggressive interest rate cuts by the central bank and continued fiscal slippage threaten to bring inflation back. In a downside scenario, a sizeable increase in inflation in late 2009 or early 2010 could compel the central bank to raise interest rates early, potentially putting a brake on growth just when Turkey should be starting to recover.

--A return to global market volatility. Turkish asset prices correlate strongly with global market trends, which have been relatively calm since mid-March. A return to the volatility seen in late 2008 and early 2009 would likely bring a return of stress to Turkish markets and exacerbate Turkey's vulnerabilities. In particular, a large and precipitous lira depreciation would complicate firms' abilities to cover their large external debt payments and, in a worst-case scenario, threaten corporate defaults and cause depositors to move from lira to FX. Moreover, a return to global volatility would likely see a rise in government bond yields, leading to debt sustainability and crowding out issues similar to those described in paragraph 2 above.

-- A prolonged recession in Europe. The EU represents 42 percent of Turkey's export market and has been slow to recover, worsening Turkey,s own recession. Slower-than-expected global recovery, particularly in Europe, would exacerbate this trend. Many analysts expect Europe to be among the last regions to recover from the global recession.

-- Further deterioration in global credit conditions would limit Turkish firms' access to external credit and further challenge their ability to roll over external debt, with effects similar to that described above. This would particularly be the case in a "crowding out" scenario, in which the GOT's borrowing takes up a disproportionate share of available domestic credit.

Why an IMF Program Matters

¶4. (C) An IMF program would significantly lessen many of Turkey's vulnerabilities and help to guard against the risks described above. Large disbursements (totaling roughly $30 billion over three years) deposited at the Turkish Treasury would allow the GOT to lower its borrowing requirements, freeing up bank liquidity to be lent to the private sector instead and smoothing Turkey,s path to recovery. Much of this new lending would likely be in the form of FX loans to firms facing large external debt payments and, as such, would also serve to reduce concerns over Turkey,s external financing gap, making it easier for Turkish corporates to continue to borrow abroad. At the same time, the fiscal requirements of an IMF program would help to ensure consolidation of the GOT,s fiscal balances, which would put its fiscal and debt picture on a more sustainable path and reassure markets and investors, keeping government bond yields in check. It also would serve as a buffer against any global headwinds.

¶5. (C) However, Turkey and the IMF remain far apart on negotiations for a program. Disagreement centers on the size and quality of fiscal adjustment necessary to achieve a sustainable debt path, as well as structural reforms to be taken in the medium term. Prime Minister Erdogan does not appear to want a deal and Turkey does not appear to need a program while markets are friendly, the private sector's external payments remain relatively light, and government bond yields are contained. However, a change in any of these for the worse, at a time when Turkey does not have the finance or credibility that an IMF program provides, could add significant stress to the Turkish economy. In short, an IMF program would be good insurance against significant and real financial risks.

¶6. (C) Of more importance, perhaps, to GOT leadership is the limited political upside that the IMF offers. PM Erdogan has succeeded with much of the Turkish public in blaming Turkey's recession on purely external factors. The AKP's business support comes largely from less export-dependent SMEs in the Anatolian heartland that care less about an IMF program than do large Turkish corporates, and the IMF is generally highly unpopular in Turkey. Moreover, it is hard to come up with a politically attractive scenario for the GOT to sign an agreement with the IMF. Even if the GOT signs an IMF deal and restores international investor confidence, Turkey will not have a strong recovery unless European export markets also recover quickly. Conversely, if the GOT expects Europe to recover, it will count on a growing economy to fix its economic woes and will feel little need for an IMF program. From this sort of calculation, the GOT has adopted a wait-and-see approach with regard to the IMF. If the optimistic scenario for global recovery comes to pass, the GOT can claim that not taking an IMF program was the right decision. If one of the negative scenarios outlined above comes to pass, the GOT can likely conclude an agreement with the IMF fairly quickly, without the political downsides of signing before the economy experiences real stress.

Visit Ankara's Classified Web Site at
http://www.intelink.sgov.gov/wiki/Portal:Turk ey

JEFFREY